

The IMF under Fire

By Daniel Kaeser, former IMF Executive director

The International Monetary Fund (IMF) is a powerful institution supporting the globalization of the World economy. According to its Articles of Agreement (the Fund Charter), it has been created at the end of the Second World War mainly *to facilitate the expansion and balanced growth of international trade, and to contribute thereby to the promotion and maintenance of high level of employment and real income....; to shorten the duration and lessen the degree of disequilibrium in the international balances of payments of members,.... to give confidence to members by making the general resources of the Fund temporarily available to them under adequate safeguards, thus providing them with opportunity to correct maladjustments in their balance of payment without resorting to measures destructive of national or international prosperity.*

Presently roughly fifty large and small member countries, or almost a third of the membership need the Fund's intensive care, i.e. they have to implement the Fund's economic and financial conditionality in order to draw on its resources. The Fund is also playing a key role in the resolution of the recurring financial crises which are plaguing the emerging countries. That is why it is subject to intense scrutiny and criticism by governments, NGOs, academics and media. Joseph Stiglitz, Nobel Prize for Economics and former member of the World Bank's management is making a fortune by bashing the IMF in a book which has become a best seller in the developing world.

Criticism is directed on the one hand at the IMF governance: in a nutshell the IMF is seen as an undemocratic institution, the decision making and operations of which lack transparency and accountability. On the other hand the economic programs imposed by the IMF on borrowing member countries are not getting unanimous support, to say the least.

I The governance in question

The IMF appears to be an undemocratic institution because the developing countries, which make up 85 percent of the Fund membership, command only 40 percent of the voting power. One has to realize that the same disproportion comes up in all international financial organizations. They do not follow the principle "One country, one vote". They are based on quotas, which represent the contribution of members to the organization's capital and determines their voting rights. A big industrial country, which is contributing large amounts of convertible currencies would not accept to be given the same voting rights as a small developing country, which will only borrow from the organization. However the countries' situation change over time, making quotas' adjustment necessary. Is it possible to make the repartition of quotas 1) more equitable and 2) more democratic? The answer to the first question is yes, also if this requires time; and to the second question probably no.

The general review of the Fund's quotas taking place every five years follows two purposes: adjusting the IMF capital basis to its financing needs and making room for selective increases allowing to bring the quotas of rapidly growing economies more in line with economic

realities. The rationale of selective increases is the beneficiaries' ability to provide additional resources to the Fund. The candidates for such increases are industrial countries like Spain, with relatively low quotas, as well as dynamic emerging countries. However the scope for such adjustments is limited, because this is a zero-sum game. What is given to the ones in terms of quotas reduces the voting power of all other members and every adjustment requires a majority of 85 percent, so that sweeping changes cannot be expected.

The quotas are calculated on the basis of a complicated formula assigning different weights to GNP, official reserves, current external payments and receipts, the variability of current receipts, and the ratio of current receipts to GNP. Work never stops on "improving" the formula., but it is generally agreed that it has to be directed mainly at meeting the financing needs of the organization. Presently there is a tendency to further increase the weight of the GNP., i.e. of economic growth in the formula. This prevents a shift of the voting power toward the slow growing developing countries, which represent more than half of the Fund membership. Needless to say, Switzerland with its slow growing economy is bound to lose over time some part of its relative voting rights.

One way to beef up the weight of the developing countries would be to increase the so called basic votes. According to the Articles of Agreement, each country receive 250 basic votes in addition to one vote per SDR 100.000 of its quota. An increase in basic votes would be especially welcomed by the small developing countries, but it requires an amendment of the Articles. As an amendment has to be supported by 85 percent of the voting power " the necessary broad consensus has not yet materialized " to use the Fund-speak.

Nevertheless, different features mitigate the effects of what is perceived as an imbalance in the repartition of quotas in favor of the industrial countries.

First, the access to the Fund resources surpass by far the size of a country's quota.

Second, the special majorities of 70 or 85 percent required for important decisions represent an efficient protection for minorities. For instance the developing countries blocked a draft amendment of the Articles of Agreement that would have given the IMF jurisdiction to pursue capital freedom. Needless to say, special majorities are a double edged sword, because they give the United States a veto right on all important decisions.

Third , the representation of the developing countries in the Executive Board is larger than their combined quota share. The developing countries (including Russia) take twelve out of the twenty four seats on the Board. Seven out of the twelve "industrial" constituencies are mixed and include developing countries or countries in transition. Their interests are fairly taken into account in the statements of these chairs.

Fourth, the decision making by consensus protects also the interests of the developing countries. It has become the target of critics from NGOs and academic circles because it lacks transparency. However one has to realize that reverting to formal voting would become a source of frustration for the developing countries, as minority shareholders.

In his essay "Governance at the IMF" (International Monetary Fund, Pamphlet Series No 53, 2002) van Houtven, former IMF Secretary, recall that, in the view of the founding fathers, the wide jurisdiction and far reaching mandate of the institution called for a cooperative framework in which policy would be set by all and for all. According to a basic rule of the Fund, "the Board Chairman should ordinarily ascertain the sense of the meeting, in lieu of a formal vote". The Board works as a college of officials who devote themselves full time to the tasks and purposes of the IMF. (quote) "Executive Directors are not subject to time constraints in expressing their positions, reservations and questions, including often successive interventions in response to questions and arguments of others. In that environment, the influence of an individual Director on IMF policies and decisions can – and frequently does – reach well beyond his or her voting power. Technical expertise is important, persuasiveness, diplomacy, sense of timing and length of service count a great deal on the influence that an Executive Director can exert.... On complex issues there is generally an understanding that nothing will be decided until everything is agreed." (van Houtven, p 23-24).

Further on, van Houtven expresses the fear that the consensus building process might be put into jeopardy by the Group of Seven, (which became the Group of Eight by the inclusion of Russia). The major industrial countries (quote) "which command close to one half of the voting power in the IMF, have exhibited a growing tendency in recent years to act as self-appointed steering group or <Directoire> of the IMF. Recent reports of the finance ministers to the heads of state and government at the annual summit meetings have sometime tended to deal with IMF matters in a manner that raises the question of whether they will leave the Executive Directors representing the Seven Countries with the necessary margin for discussion and room for give and take that is essential for consensus building." (van Houtven, p 30-31).

As a matter of fact, the ganging up on the Fund by the G 7/8 is a worrisome development, and this for three reasons. First it undermines the cooperative nature of the institution, based, as we said, on consensus building, and replaces it by the unilateral leadership of the major stockholders. Second, it allows the major industrial countries by way of mutual complacency to water down as far as they are concerned the surveillance of economic policies exerted by the Fund. Yet at the outset they wished to replace the Fund surveillance by their own policy coordination, which was supposed to work through peer pressure. These efforts have subsided in the late 1980s. Third, since then, the members of the G7/8 are mainly concerned by the promotion of their own agenda. In spite of the lack of transparency and accountability characterizing its functioning, it seems that the strength of the G 7/8 results from the frequent meetings and ongoing consultations between the deputies of the finance ministers, i.e. the heads of the G7/8 Treasuries, who are close to the banking community. Those who are focusing their critics on the veto power of the United States in the Fund should better have a closer look at the activities and behavior of the G 7/8. It represents the cutting edge of the Economic Summits initiated not by the United States, but by France in 1975 in Rambouillet. That this < Directoire> is drawing growing criticism should not be a matter of surprise.

In addition to the distribution of quotas, one aspect of the Fund's governance which attracted criticism from the civil society, academic circles and the medias has been its lack of transparency. When Switzerland joined the Fund in 1992 it was still a very secretive institution. After the Swiss authorities had published the first report on the Fund's consultation

with our country, I had as new Swiss executive director to appear like a "bourgeois de Calais" in front of my colleagues at a special Board meeting urgently called together by the management. The Swiss authorities were unanimously blamed for breaching the club rules! Since then the Fund made commendable progress in the field of transparency, a change which has been partly induced by the growing influence of the civil society in rich and poor countries and the need for the Fund to improve public understanding of its policies and operations. For instance Chairman's statements, news briefs and press releases following Board discussion on the lending of Fund resources are released on a routine basis. There is a presumption that the documents setting out the authorities' intentions under their IMF-supported program will be released to the public. Staff papers discussing key policy issues and summaries of Executive Board discussion of these papers are now readily available. For the review of the crucial and controversial issue of the economic and financial conditions (conditionality) linked to Fund credits, public comment has been sought and seminars with wide participation of academics, policymakers and non governmental organizations have been organized. As to the relations with the membership, a large majority of members accept the publication of a public information notice summarizing the periodic consultation with the Fund on their economic situation and policies in the framework of the so called bilateral surveillance. In 2002, 106 members have published on a voluntary basis the full staff report on these consultations, a move for which Switzerland had been unanimously blamed ten years ago. Last but not least an independent evaluation office began operating last year. The IMF website shows the impressive progress made by the Fund in the field of transparency

Critics of the Fund policies

The second part of this article deals with the conditionality imposed by the Fund on the use of its financial resources, which attracts much criticism. A special section will be devoted to the case of so called emerging countries that have access to the financial markets and might lose it in the wake of a financial crisis.

When facing serious balance of payment problems and proving unable to mobilize support from other sources a member country (practically always a developing country or a country in transition) will ask the Fund for help. The Fund will activate one of its credit mechanisms best suited to this member country's problem under the condition that it pledges to take measures and to follow policies that should bring it back to a sustainable position. Usually the borrowing country undertakes to lower the value of its money if it is overvalued and to follow tight monetary and fiscal policies. As the roots of its problems are often entangled in the structures of the economy, the borrowing country has to take various measures aiming at improving them. These measures are normally based on the so called "Washington consensus" (deregulation, liberalization and privatization), with a view to increase the productivity, attract investment and stimulate export.

The austerity policy that the borrower has to follow is often criticized, but no country can afford to spend more than what it is taking in. The size of the adjustment that is to be performed within a reasonable period of time is not arbitrarily dictated by the Fund. It depends of the scale of the problem that is to be solved. What can be argued about is the way in which the

borrower's authorities are distributing the adjustment's burden. Many Governments would be tempted to impose little restraint upon the army and the police, to think that the countryside can bear more than the big cities and to cut expenses in the field of health and education in order to be able to pay the civil servants. That is why the Fund requires the borrowing countries to establish a well targeted social safety net protecting the poorest layers of the population and to maintain at a reasonable level the expenses for health and education. Unfortunately, in reality, the social safety nets do not always prove as good as they look on paper. After being put in the budget with reasonable expenditure amounts the health and education sectors are among the first to be curtailed when the State income fails to meet the budgetary assumptions. Administrative decentralization is fashionable nowadays, but it might lead to a further impoverishment of local communities if the transfer of responsibilities to the lower level of administration does not go hand in hand with a corresponding transfer of budgetary resources. In that case the administrative decentralization represents an easy way of alleviating the budgetary discipline imposed by the Fund. A closer monitoring of the program implementation would help to reduce these shortcomings.

If the measures based on the "Washington consensus" usually make sense, in some cases the timing and sequencing of their introduction do not. Contrary to what Stiglitz would like his readers to believe, the World Bank is in this respect no less to blame than the Fund, because both institutions practice what is called "cross conditionality": each of them asks the borrowing country to fulfill the conditions set by the other. One example is what has been done in the field of privatization. By no doubt the change from the command to the market economy requires the privatization of State enterprises, but in the former Soviet Republics this process has been pushed ahead in a kind of frenzy. The IMF and World Bank teams in charge of the different Republics were competing to speed up the process and the progress was proudly displayed on glossy diagrams. But the privatization did proceed under the worst possible conditions. The hyper-inflation had destroyed the savings of the population, the banking system was in shambles, capital markets did not yet exist, the legal system and the judiciary did not give a fair protection to the property rights, so that foreign investors were not ready to participate. As a result, the Republics were despoiled of valuable assets which were in many cases transferred for little money to members of the old "nomenclatura". The best solution would have been to liquidate the loss making State enterprises, to put the others under strict budgetary constraints and to strengthen their management until the preconditions for a fair privatization would materialize. In the agricultural sector collective farms were dismantled, land and cattle were allocated to workers who had little farming skill, little farming equipment, no financial resources to buy inputs and no access to credit because the old rural credit institutions had been scrapped and new ones did not yet exist.

One can also wonder about the timing chosen for the introduction of other measures belonging to the "Washington consensus". The Kyrgyz Republic for instance has been encouraged at an early stage of the transition to make her currency fully convertible, to lower its customs tariffs to a minimum and to join the WTO. These measures were not enough to attract many foreign investors. Yet the convertibility facilitated the capital flight, the dollarization of the Kyrgyz economy and the transfer to the US Treasury of a large part of the Kyrgyz monetary seignorage. The lowering of the customs tariffs deprived the Kyrgyz State of badly needed fiscal resources and promoted the import of foreign cars and durable goods by affluent Kyrgyz citizens

operating in the shadow economy. Becoming a member of the WTO was of no immediate avail to the Kyrgyz Republic, but triggered a trade war with the neighboring countries, which have not yet been settled.

These shortcomings represent the negative side of the IMF's management style, which is otherwise quite efficient. It is characterized by a strong centralization and by an overwhelming concern for coherence, homogeneity and economic orthodoxy. This leads to the elaboration of standard policies introduced in borrowing countries by a staff which demonstrates a sense of hierarchy and discipline unequalled in most national administrations. What is missing is an alarm system which would signal to the management when, where and why its standard policy is backfiring. This could be the role of the Fund's resident representatives in borrowing countries, but their assignment is usually too short to allow them to look behind the mirror and their culture does not make them eager to question the views of their lords and masters. What is needed is an institutionalized dialogue with the civil society of the borrowing countries to assess the real impact of the Fund's program. This dialogue should include bilateral donors' senior representatives who have field experience.

The role of the Fund in the international financial architecture

The most controversial aspect of the Fund's activity is its dealing with the capital movements and financial crises.

The Articles of Agreement stipulate that members should liberalize payments and transfers for current international transactions, i.e. transactions directly linked to the functioning of the real economy, such as payments for visible imports and for services, including interests and transfer of profits and dividends by foreign investors. They forbid borrowing from the Fund to finance capital transfer.

Yet in the course of the last decades under the umbrella of the already mentioned "Washington consensus" shared with the Treasuries of the industrial countries the management and the staff of the Fund actively promoted the idea that the liberalization of international capital transactions would help to speed up the growth of the developing countries. This idea might lack sufficient empirical evidence, but it led to an attempt to amend the Articles, which was – as previously said- foiled by the opposition of the developing countries and by the outburst of the Asian crisis. Ironically, the staff and the management of the Fund i.e. of an institution which has been created to mitigate the failures and the shortcomings of the market, are absolutely convinced that the market cannot make mistakes. The second article of faith of the Fund is that the market will pitilessly punish at an early stage countries which are stepping out of the path of economic virtue, provided that timely and accurate data are made available. That is why transparency has become the centerpiece of the crisis prevention. Nobody can honestly be against transparency. One wonders then why, in spite of increasing transparency, the market waits so long to castigate erring countries. The answer is simple: because of the irrational exuberance of the market participants. During the last years the interest-rate spread between US Treasury bonds and the average Latin American bond did never fall below 6 percent and rose two times up to 12 percent. Such profit opportunities represent an irrepressible temptation for investors hardly pressed to show every three months growing profits in their balance sheets. The

temptation is even greater as there is a fair prospect that the borrowing country will be bailed out by the IMF. For emerging countries easy access to debt financing represent also an irrepressible temptation to borrow and to escape the necessary budgetary discipline. This double irrational exuberance paves the way to financial crises. In spite of the fact that it never got its public finance in order, Argentina was a darling of emerging market bond investors. The Fund, which was aware of the danger of the situation, did not blow the whistle, probably fearing that this would trigger the crisis it was supposed to prevent.

After the outbreak of a financial crisis the Fund will sooner or later bail out the country, but not without requiring it to perform a large fiscal adjustment. This will bring it in a severe recession that will spread over to its trading partners. The main reason given for this strong adjustment is to restore the confidence of the investors. Yet this practice contradicts the Articles of Agreement, which dispose that the lending of Fund resources to members should provide them " with the opportunity to correct maladjustments in their balance of payments without resorting to measures destructive of national or international prosperity."

Obviously, the only possibility to solve financial crises while respecting the principles set out in of the Articles of Agreement would be to create an international mechanism for the orderly restructuring of debts. It is interesting to recall that this idea has already been floated in 1989 by a high ranking working party set up by the Swiss ministry of finance and chaired by the former Governor of the Swiss Central Bank, Languetin. Building on that idea I worked out in 1990 the blueprint of a " Fair system of debt resolution" for a Swissaid forum. These ideas proved premature at that time. In November 2001 though Anne Krueger, first deputy general manager of the Fund, proposed a Sovereign Debt Restructuring Mechanism (SDRM), which was discussed at length and adapted according to the remarks made in the course of the discussion. The proposed SDRM enjoys a large support without reaching yet the 85 percent majority required for an amendment of the Articles of Agreement. But something should be clear: the international financial architecture in which the Fund has to operate will remain shaky until it integrates an international debt resolution mechanism.